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Editorial

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EDITORIAL

The Profession Is Bereaved

Adam Averell Ross died at his home in Ardmore, Pennsylvania, on Saturday, June 15th, and was buried near his summer estate on the eastern shore of Maryland. His going creates a vacancy in the profession of accountancy which will not be wholly filled. Other men will come into the field well equipped and ready to advance the interests of accountancy. They will have abundant opportunity for the exercise of their talents and goodwill. But when one of those who labored when the profession was young passes from the scene there is always a feeling that something has gone for which there can never be full compensation. The men who have grown up with accountancy in America know the name Adam Ross even if some of them in remote parts of the country had not met him. In the early days he was one of the few who built up a profession in Pennsylvania, but his view of things was never obscured by state lines. He always believed in the national breadth of accountancy and was active in the administrative and other affairs of the old American Association of Public Accountants and its successor, the present American Institute of Accountants. Until his final illness made it impossible for him to participate actively in the work of the Institute he took an important part in the functions of the organization. He served for several years as treasurer and was a member of council and of many committees. He was an accountant of the kind which has made the profession estimable. He was a kindly, lovable friend and a delightful companion. Above all he was a Christian gentleman.

Accountant Not Liable to Third Parties

It seems probable that the decision of the supreme court of the state of New York in *Ultra Mares* v. *Touche, et al.*, reported in the *New York Law Journal*, June 14, 1929, will become a leading case, and if, in the event of appeal, the judgment be confirmed it will constitute a precedent of the utmost importance, not only to accountants, but to all professional men whose services to clients may be the object of attack by third parties. It is remarkable that such a precedent was not set long ago. There have been other cases in which the responsibility of accountants was involved—for example, the Kingston Cotton Mills case is familiar to every accountant, and there are other noted cases which bear upon the duty and the liability of the accountant—but in the Ultra Mares Corporation matter the controversial question of what might be called the breadth of responsibility is brought squarely forward, and the court decides, as it has always seemed inevitable that a court would decide, against the rather preposterous theory that an accountant or other professional man has a pecuniary or even a moral responsibility to persons outside the contract who subsequently may have, or may claim to have, an interest in the fruit of the contract. There has been a great deal of loose talk about holding professional practitioners to account for the whole effect, foreseen or unforeseen, of their professional acts. And, in truth, it is a noble theory that each one of us should be charged with the effect of the furthest ripple spreading from every pebble he flings in every pool. As a tenet of philosophy, the doctrine of total liability is debatable. As a practical method it does not merit consideration. Like many fine-spun theories, this one will not carry weight and it snaps at the first strain. To apply it to the affairs of today would induce chaos and clutter up the courts with an inextricable tangle of suit and counter-suit. We should be litigated to death.

A Momentous Decision

The Ultra Mares case was ideal in many ways. It had all the elements which were needed to make a clear-cut issue. We may differ radically from the court in its reference to the question of negligence, but that is not the point at issue now. The fact is that the court apparently adopted the view expressed by the jury on this point. To the parties concerned in the suit this is an important matter for personal reasons, and the negligence assumed may not seem to have been demonstrated by the evidence. To the public it is important, because it strengthens the force of the court's decision which finds that even where negligence may be assumed liability to third parties does not arise. The language of the decision may become classic. In future one will often hear the expression "to assume a potential liability to practically the entire world." The full text of the decision is brief. Its significance to the accounting profession is great. Mr. Justice Walsh said:

"This action was tried before the court and a jury and resulted in a verdict for the plaintiff. Motions were made at the close of the plaintiff's case and again at the conclusion of the trial to dismiss the complaint upon which decision was reserved. After the rendition of a verdict a motion was made to set same aside, as to which decision also was reserved. Defendants are public accountants. In February of 1924 they were employed by Fred Stern & Company, Inc. (hereinafter referred to as Stern), to audit its books and prepare a balance sheet as of December 31, 1923. The audit was made and the balance sheet prepared. Attached to the balance sheet was a certificate of defendants attesting to their examination and certifying that the balance sheet was in accordance therewith and represented in their opinion a true and correct view of Stern's financial condition as of December 31, 1923. Defendants negligently performed their work. The balance sheet prepared by them was incorrect and showed Stern to be a going concern with assets greatly in excess of liabilities, whereas had defendants' audit been carefully made the balance sheet would have shown that Stern was insolvent. Defendants were not informed by Stern that the balance sheet was to be used by it for any particular purpose or that the same was to be presented to any particular person or persons. They knew generally that the same would be used by Stern to evidence its financial condition; that it probably would be exhibited to banks or to creditors or to stock brokers or purchasers or sellers; that balance sheets prepared by auditors are used for the purpose of securing credit and that the balance sheet furnished by them might be used by Stern to extend loans, secure credit and to induce banks and others to advance money to it; also that lenders to whom Stern might apply for loans would probably rely upon the balance sheet as indicative of its financial condition. Beginning in March, 1924, and continuing for the balance of the year, plaintiff advanced to Stern large sums of money, relying upon the correctness of the balance sheet prepared by defendants. In the latter part of 1924 Stern was adjudged a bankrupt. Some of the moneys so advanced were not repaid to plaintiff. It is to recover the amount of these unpaid advances that this action was brought. Negligence is not actionable unless there is a breach of a duty owing by defendants to plaintiff. There must exist between the party inflicting the injury on the one injured some privity by contract or otherwise by reason of which the former owes some legal duty to the latter. Contractually, defendants owed no duty to plaintiff because no such relationship existed between them, nor was there such privity between the plaintiff and the defendants as to impose upon the latter a liability to the former for their negligence in performing their contract obligation with Stern. While in this state a party may sue on a contract made expressly for his benefit, though he is not a party thereto, the doctrine has not been extended so as to place upon the promisee under a contract a duty to all who either potentially or incidentally may be beneficiaries thereof. The doctrine of beneficial interest is recognized as an exception to the general rule, which proceeds on the natural presumption that a contract is intended only for the benefit of those who are parties to it, and therefore before a stranger can avail himself of its benefits he must at least show that it was intended for his direct benefit. The right of the beneficiary to sue on contracts made for his benefit is confined to a limited class of cases (*Scaver* v. *Ransom*, 234 N. Y., 233), in which this neither categorically nor in principle is included. To hold that defendants' duty extended not only to Stern, but to all persons to whom Stern might exhibit the balance sheet and who would act in reliance thereon, would compel defendants to assume a potential liability to practically the entire world. The law does not go so far, but limits the liability to those for whose direct benefit, to defendants' knowledge, the work for Stern was performed (*Savings Bank* v. *Ward,* 100 U. S., 195; *Day* v. *Reynolds,* 23 Hun, 131; *Glawatz* v. *Peoples Guaranty Search Co.,* 49 A. D., 465; *Derry* v. *Peek,* L. R., 14 App. Cas., 337; *Le Lievre* v. *Gould,* 1 QB., 491; *National Wire & Steel Co.* v. *Hunt,* 312 Ill., 245). The cases relied on by plaintiff are no authority to the contrary. In *Glanzer* v. *Shepard* (in 233 N. Y., 236) plaintiff, to defendant's knowledge, was a direct beneficiary of the work performed by defendant. So also in the cases in other jurisdictions where liability has been fastened on abstracters, notaries, inspectors, etc., for negligently furnishing a certificate or performing work, it has invariably been shown that the work was to be performed or the certificate made to the knowledge of the one performing the work or issuing the certificate; that the same was for direct use and benefit of the injured persons (*Economy Building & Loan Ass'n* v. *West Jersey Title Guaranty Co.,* 64 N. J. L., 27; *Denton* v. *Nashville Title Co.,* 112 Tenn., 320; *Murphy* v. *Fidelity Abstract & Title Co.,* 114 Washington, 77; *Western Loan Co.* v. *Silver Abstract Co.,* 31 Mont., 448). *International Products Co.* v. *Erie R.R.* (244 N. Y., 331) merely holds that a negligent statement when acted upon by one to whom a duty is owing may be the basis for the recovery of damages. *McPherson* v. *Buick Motor Co.* (in 217 N. Y., 382) is an extension of the doctrine of *Thomas* v. *Winchester* (6 N. Y., 397), as liberalized by *Devlin* v. *Smith* (89 N. Y., 470) and *Statler* v. *Ray Manufacturing Co.* (195 N. Y., 478). The rule in these cases is that a person supplying goods or machinery which may be used by others, which articles were negligently made, are reasonably certain to place the lives and the limbs of others in peril, is under a duty to make same carefully, and the right to enforce liability for the manufacturer's negligence is not confined to the immediate buyer, but extends to the persons or class of persons for whose use the thing is supplied. Liability in such cases is held to rest not upon contract or direct privity between the manufacturer and the persons injured, but upon the general duty which the law imposes on everyone to refrain from doing that which is dangerous to the lives and limbs of others. This doctrine has not been extended beyond personal injury cases. As defendants were under no duty to plaintiff, no cause of action against them has been established, and hence the complaint must be dismissed. This determination renders unnecessary a consideration of the other grounds urged by defendant to set aside the verdict. Submit order on notice.

Analogies in Other Professions

At first reading there may be a slight feeling of regret in the minds of a few perfectionists who will find in this decision something a little short of the ideal. Someone may say that the limitation of responsibility of the accountant detracts from the prestige of accountancy. Many will feel that there is a danger in the repudiation of the theory of wide-spread responsibility; but, on the other hand, it is inconceivable that a judgment for the plaintiff could have been given by any competent jurist. Let us consider an analogous case in another profession in order to see what might be the result of attempting to apply the doctrine of "liability to the entire world." A man consults his family physician, submits to an examination and obtains from the physician a statement to the effect that the patient is sound in wind and limb. The patient may say to the physician that his certificate is for the purpose of presenting it to some life-insurance company, yet to be selected, in support of an application for insurance. Upon receipt of the physician's certificate the patient visits the office of an insurance company and presents the medical certificate, which is accepted by the company because it bears the name of a physician known to be of good standing. The policy is written and issued and shortly thereafter the patient develops symptoms of tuberculosis, which must have been in his system at the time of the medical examination. The physician, let us say, was negligent because he did not make those tests which he might have made had he suspected the existence of tuberculosis. He relied to some extent upon his knowledge of the history of the patient and made merely an examination of a somewhat superficial character. If the theory of total liability were to prevail the insurance company in this supposed case could claim from the physician the total amount of money paid to the beneficiary of the policy in the event of death from tuberculosis. Surely, no sane person would argue that such a burden of responsibility would rest upon the physician's shoulders. Or suppose that a man intending to construct an office building instructs an architect to prepare plans and specifications. These are accepted and the building is erected. Subsequently, a company purchases the building from the original owner for use as a warehouse. After the transaction has been consummated it is discovered that there is a structural weakness which will prevent use of the building for the purposes intended by the buyer. Would anyone contend for a moment that the purchasing company could hold the architect responsible financially for any loss or damage which might result from that weakness?

What Fees When the World is Client?

The whole truth of the matter is that the accountant is engaged in a profession whose service chiefly consists of rendering an opinion. The opinion truly is based upon investigation and analysis, but it is still an opinion nevertheless. If persons not directly concerned in the arrangement made by the accountant and his client suffer loss because they depended upon the opinion of the accountant, it is unfortunate for them.

Nevertheless, the fact remains that they are third parties. If the accountant, or any other professional man, is to be called upon to bear a burden of responsibility to the entire world there will have to be a great reform in the matter of fees. It is an axiom of business that payment shall be based to a great extent upon the element of risk involved. The iron worker who imperils his life day by day on sky-scraper construction is paid a far higher wage than he would receive for the same kind of work on the ground. The man who works in certain departments of a wire mill is paid for one day what men in other factories may receive for a week's labor. So it should be in the professions—the man who assumes the risk of responsibility to everyone, past, present and future, must fully deserve and receive a scale of compensation out of all proportion to the actual time and labor involved in the preparation of his work. We do not imagine that the clients of accountants would be eager to encourage the adoption of any such principle as that of total liability were it accompanied by the perfectly fair corollary of enormous fees. The amounts which accountants now receive for their services are not, as a rule, excessive. Sometimes one hears of an absurdly high fee, but in the common run there is no excess.

Decision Legal and Sensible

But even assuming that a great advance in fees might be obtainable, it seems doubtful if any professional man would care to pursue his vocation in the face of a world-wide liability. It is gratifying to find that the decision of the supreme court of New York follows generally the line of common sense, and it is to be hoped that the decision will discourage some of the ridiculous attempts which are being made to extort money in the form of damages from professional men. Of late years it has seemed that there must be a kind of tacit understanding among clients that when anything goes wrong the accountant should pay. Some of the suits which have been entered and dropped have been wholly ludicrous. Others, still before the courts, seem equally absurd, and others are doubtful. No one yet knows to what extent an accountant may be held personally and financially liable for losses incurred by the client himself. The Ultra Mares case disposes of the question of liability to third parties, but the more difficult question of liability to the client is not determined. Some people seem to believe that the accountant is to be held responsible for all losses. This is flattering, of course, but annoying. Sometimes it seems to make no difference whether the accountant was engaged before, during or after the occurrence of the loss. He should have known all about what had happened or could happen. If he was found to have warned his client and his advice had been ignored, he was still to blame because he had not insisted upon precautionary or redemptive action. If the accountant's activities were limited by the terms of his engagement so that he could not have known or discovered the unsoundness that afterward expressed itself in misfortune, it would make no difference whatever—he was an accountant, he should possess superhuman faculties of discernment and the evil should not have happened. The world has been looking these many centuries for a personal devil who could be caught, kicked and compelled to pay what is lost. If the accountant is as omniscient of good and evil as some would have us believe, we have at last overtaken the culprit. There may be some question of the sufficiency of the purse of evil to make good all that has gone glimmering in the devious march of business—but that is a topic for another day.

Other Decisions Are Wanted

Within the past two or three years there has been a whole wardrobe of suits against accountants, based, it appears, upon the notion that the accountant is legally liable for everything that goes wrong. The amount of damages named in some of these suits is as magniloquent as a war-loan appeal. We are not now attempting to argue that the accountant is not responsible to a certain extent for errors in judgment. Every man is responsible for such things, but we have grave doubts as to the extent of such liability. In one well known case it was decided that the amount to be recovered by the plaintiff was the fee actually paid to the accountant. In other cases where damages of great amount have been named, there has been settlement in small amount out of court. The truth is that there is nothing in the form of judgment which can be cited as an absolute precedent for the assessment of damages based upon the extent of loss. The Ultra Mares case, we hope, settles for all time the contention that third parties may participate in damage suits except where damage to life or limb is concerned. What is needed now to complete the record is a decision by some competent court on the extent to which an accountant may be held responsible for damage and loss in certain circumstances. For example, it would be eminently desirable to have a judgment in a case in which the accountant was clearly shown to have been negligent. There should also be a decision in a case in which the accountant was merely too superficial but not actually negligent, and there should be a judgment in a case in which the accountant was shown to have exercised every reasonable precaution and still failed to discover faulty conditions. We do not believe that it is necessary to have a decision of a case in which the accountant is found guilty of fraud. That sort of thing is covered by an abundance of legal precedent.

Verification of Financial Statements

The Federal Reserve Board and the American Institute of Accountants have cause for gratification at the instant response which followed the publication of the revised pamphlet, *Verification of Financial Statements*. The first printing was exhausted within a few weeks and the number of orders continues to increase. The matter appeared first in THE JOURNAL OF ACCOUNTANCY for May, 1929, and the sale of that issue of the magazine indicated an intense interest in the text. Now the immediate demand for the pamphlet reprints published by the reserve board has exceeded the expectations of nearly everyone. But that is not the most significant result of publication of the instructions. The astonishing thing is that critics usually captious have not found anything to condemn. The committee which wrote the document must have done a thoroughly good job. One of the ways in which the lessons contained in the pamphlet can be most effectively inculcated is that adopted by the California State Society of Certified Public Accountants. That society has not only approved the instructions, but adopted them. The action of the society was recorded in the *Bulletin* of the American Institute of Accountants, July 15th, but the matter is important enough to merit repetition. The following resolutions were unanimously adopted by the society:

No. 1

WHEREAS, the California State Society of Certified Public Accountants' committee for coöperation with bankers and the committee on credit practices of the California Bankers Association have recommended that the requirements set forth in the revised bulletin, styled *Verification of Financial Statements*, appearing in the May, 1929, issue of THE JOURNAL OF ACCOUNTANCY as the basis of standards for certification of financial statements be adopted; now therefore be it

Resolved, that the California State Society of Certified Public Accountants determine that the minimum requirement for certification of financial statements shall be the standards set forth in the May, 1929, issue of THE JOURNAL OF ACCOUNTANCY under the title *Verification of Financial Statements;* be it further

Resolved, that if said minimum requirements have not been observed in preparing said statements, each member of the California State Society of Certified Public Accountants responsible for such certificate will indicate on the balance-sheet or so qualify the certificate appended to said statements as to make full disclosure showing wherein such minimum requirements have not been complied with; be it further

Resolved, that a copy of this resolution and the report of the committee for coöperation with bankers be forwarded by registered mail to every holder of a certified public accountancy certificate issued by the state of California; be it further

Resolved, that an appropriate committee of the California State Society of Certified Public Accountants be empowered to adopt rules and regulations for the carrying out of the intent and spirit of this resolution, including the right to consider complaints and make recommendations to the board of directors thereon, and be it further

Resolved, that a copy of this resolution and the report of the committee for coöperation with bankers be transmitted to the chairman of the committee on credit practices of the California Bankers Association to be presented at the forthcoming annual convention of the California Bankers Association.

No. 2

WHEREAS, the California State Society of Certified Public Accountants has adopted a resolution establishing minimum certification requirements and has provided for the creation of a committee to be charged with the responsibility of carrying out the intent and spirit of such resolution; now therefore be it

Resolved, that a permanent committee of the California State Society of Certified Public Accountants, to be styled the committee for coöperation with bankers, be created, consisting of the presidents of the San Francisco and Los Angeles chapters of the society together with two additional members from each chapter of the society to be appointed by the president of the California State Society of Certified Public Accountants; be it further

Resolved, that in order to preserve continuity of the policies of such committee its members other than the presidents of the San Francisco and Los Angeles chapters be appointed for a term of three years, and be it further

Resolved, that any vacancies which occur in the personnel of the committee other than those arising from the expiration of term of office, as hereinabove provided, be filled by the president of the society; be it further

Resolved, that the committee herein created for coöperation with bankers be and is hereby empowered jointly with the standing committee on complaints to adopt rules and regulations for the carrying out of the intent and spirit of the resolutions adopted this day providing for minimum requirement for certification of financial statements. Such joint committee is empowered to consider any and all complaints relating to certification of financial statements. The said joint committee is, however, not authorized to take any action whatsoever in respect of any complaints except to make investigations and hold hearings and make a report and recommendations to the board of directors of the society on all complaints referred to them for consideration.

Bankers have expressed a complete readiness to encourage clients to permit the required thoroughness of investigation. Leading accountants everywhere can do much to give effect to the intentions of the authors and publishers of the pamphlet by following the example set by California.